SCHOOL OF LAW
CASE WESTERN RESERVE
UNIVERSITY

Canada-United States Law Journal

Volume 33 | Issue 1 Article 31

January 2008

The Importance of Venture Capital in Promoting Entrepreneurship - Canadian Speaker, United States Speaker

Brad D. Cherniak

Cathy Horton-Panzica

merchant banking, and private equity and venture capital, with firms like CIBC, Bank of America, Chemical Bank, and even First Ontario Fund, which is not noted in his bio, but is a labor-sponsored venture capital fund in Canada. So I think he is in a good place to comment on the pros and cons of that model of Government intervention. Brad specializes in small cap private and early stage companies both as an advisor and principal. He has served on a number of boards of directors and advisory boards for these companies.

Without any further ado, because I know Henry is getting a little impatient, I am going to turn to Brad to start the discussion on the first subject, the relationship of venture capitalists and entrepreneurs: the good, the bad and the ugly.

CANADIAN SPEAKER

*Brad D. Cherniak**

&

UNITED STATES SPEAKER

*Cathy Horton-Panzica**

MR. CHERNIAK: Let me start by saying that when I heard about this topic, I was actually quite excited to come here, because it is a topic quite near and dear to my heart. When I started in my field, my first deal was $366 million, and my last deal in March was $5 million . . . so either my career is in inexorable decline or I made the strategic decision, which I like to think I have, to focus on entrepreneurs and their companies – because I think it is a very challenging and rewarding world, and it is a great place to spend a career.

But I thought what we would do is discuss – first, can you hear me okay in the back? Is my voice carrying? Okay. We thought we would delve into the relationship between VCs and entrepreneurs . . . and that we might as well start with the dirt!

You know, if you are going to discuss a relationship, you want to start with the bad side rather than the good side. So I'm here to give you the straight goods – but, this being said, I have to say I feel a little bit duped and misled by Daniel and by this Institute, because I was brought here to sort of tell you the straight goods on deals and VCs and what really goes on in the trenches . . . but I find out I am sitting next to a reverend, and my every word is being recorded by every media imaginable. So under advice of my counsel, I would like to conclude my remarks for today . . .

So the first section really discusses what each side doesn't like about the other. And to start with the VC as the first target, what are the beefs on venture capitalists? The first one, increasingly so, is "why are their term sheets so aggressive?[20] Why are deals getting scarier and scarier, getting more complex?"

Frankly, it is the nature of the beast. It is a negotiation, with a lot at stake economically and otherwise.[21] So you are always looking for the upper hand,

* Brad Cherniak is Co-Founder and Partner of Sapient Capital Partners, a Toronto-based firm which advises mid-market and early stage companies in the areas of growth and corporate strategy, acquisitions and divestitures, and the sourcing of capital. Mr. Cherniak has close to 20 years of experience in investment research, corporate and investment banking, and merchant banking and private equity venture capital with such firms as CIBC Wood Gundy, Gordon Capital, Bank of America and Chemical Bank. Mr. Cherniak graduated Summa Cum Laude from the University of Chicago's Graduate School of Business.

* After being educated in High School by the Quakers at George School in Philadelphia, Cathy went on to graduate from the University of Michigan in 1983, The Ohio State College of Law in 1986 and The University of Kent Canterbury Theological College in England in 1999. In 2000, she was ordained as an Episcopal priest. Cathy has spent over 20 years cultivating a global mergers & acquisitions and venture finance legal practice, serving a myriad of clients that range from the Fortune 100 companies to emerging and mid-market enterprises. She spent 15 years in London, where she developed a passion for technology in the emerging companies' market place. In Europe, she formed her own consulting practice and worked with global enterprises and start-ups to foster and capture the value of strategic technology innovation. Cathy has dedicated herself to transforming economies through the creation of truly innovative business strategies using technology. While in London, Cathy served as a trusted advisor to the Cabinet Office of the Prime Minister, Tony Blair, to help generate ways in which technology development could drive economic outcomes for Britain. After her years in London, Cathy recently returned to her native United States to continue her practice of law and consult with technology driven enterprises. Cathy is the founder and leader of the Red Room Revolution, a set of 20 economic development initiatives structured to transform the Northeast Ohio Region using a technology platform. She also is a founder of the Beta Strategy Group and Beta Opportunity Partners Fund which has made a commitment to fund 24 technology companies in 18-36 months. To date, Cathy has funded 6 companies and founded 3 of her own. She also envisioned and started the Beta Technology Park in Mayfield Village, Ohio which transformed a decaying industrial park into a tech home for early stage companies to grow using a shared services platform to lower overheads. She has recently renovated an old barn to headquarter her new business, Children's Technology Workshop, which educates second to eighth graders in creative play using technology. Finally, Cathy is an Associate Priest at Trinity Cathedral in Cleveland, Ohio.

[20] *See, e.g.*, Joseph L. Lemon, *Venture Capitalism After the Burst of the Internet Bubble: Selecting Financing Terms with Care*, 2 MINN. J. BUS. L. & ENTREPRENEURSHIP 1, 5-6 (2003), *available at* http://www.centerforbusinesslaw.org/journal/v2n1/lemon.pdf (discussing aggressive term sheets).

[21] *See generally* Vivek Wadhwa, *Before You Accept VC Funding...A Veteran Entrepreneur Tells You What You Need to Look For in a Venture-Capital Firm Before You Agree to a Deal*, BUS. WK. (August 3, 2006), http://www.businessweek.com/smallbiz/content/aug2006/

and you are trying to get the best valuation possible, the best terms possible.[22]

It is also a natural, broad trend in business – as companies become more efficient, shareholders increase their expectations, all given a turbo boost by hedge funds and other activist shareholders, every side of every corporate relationship attempts to squeeze every last dime of value from their counterparties. You are forced in a sense to get more creative over time, to get more and more aggressive and scary going in.

I also think the lawyers should take their share of the blame! I have had some very creative counsels that thrilled me over the years as a venture capital fund manager, in giving me scary new implements with which to beat the entrepreneur over the head if necessary! So lawyers have to take their share of the blame!

All this being said, I think there is an interesting and even counter-intuitive sea change happening in the market. There is an interesting new trend towards simplicity and trust, and it is kind of driven by the developments I just described above. I can speak to that very well from my own experience – it is also driven by simple practical reality in such cases where you have companies where the venture capital funds are putting in multiple rounds of capital, possibly with new investors coming in on some of these different rounds. I have had these types of situations where the paper trail of documents and terms and rights and obligations becomes so complicated and convoluted and overlapping and conflicting that, despite having all these nuclear weapons, there is essentially no way to detonate them before you can get your own butt out of the room!

So what you have to do in this instance is frankly start with a blank sheet of paper and say, okay, all of us clever professionals have kind of painted ourselves into a strategic and intellectual corner here. We can't make decisions because we've got five different shareholders agreements – each more complex than the last – it becomes hard to say who trumps whom. So let's call it a draw and re-cut the pie. One can look at this situation and wonder what all the legal expense and effort was for. Simplicity is becoming more practical. It is becoming a practical thing as well as a trust-driven thing.

MS. HORTON-PANZICA: I find it interesting to blame the lawyers because during yesterday, making a list of the terms that pervade our space, and they come from lawyers: preference, drag, tag, ratchet, hatchet, laddering, pump and dump, underpricing, crowdouts, control, forced exit, rushed exit, later-stage blinders, piggyback, grand standing, flips.

MR. CHERNIAK: I have done every one of those . . . some twice!

sb20060802_804397.htm.

[22] *See generally id.*

MS. HORTON-PANZICA: If anybody doesn't know what any of that means, it is the dirty language that pervades what we are doing. And when we started talking about this session, I said, you know, why don't we talk about what we need to do as responsible professionals to change this?

I like to say that the trend that I have been trying to work with the investments that my group is doing, and in partnership with other people, is to simplify due diligence, so you don't have entrepreneurs who should be running their businesses and inventing and being creative fund people. They are spending nine months in due diligence for a million dollars that is not even spent, and having them review 15 drafts of 45 term sheets for the 45 people who are investing, and completely send them down side roads when they need to be straight ahead.

The investments that we have been doing – we don't even present the term sheet until all of the investors in the consortium agree. There is one term sheet that the entrepreneur is reviewing for everyone.

We also have a fixed due diligence program where we only do due diligence upfront on the things we really, really care about. So we are changing – actually, there are a few things we really, really care about – the intellectual property and how quickly are we going to cash flow based on the numbers we think are there.

Once we know when we are going to cash flow and whether the IP is commerciable outside of the opportunity, then we have done a lot of the de-risking already. We will not have to spend nine months in due diligence. We don't have to get into 45 term sheets, and we don't have to get into ratchets and hatchets and preference. None of that stuff is really what's on the table; we have taken all that off.

So I sort of wanted to say, in this trend about where we are going in the common beefs, is why don't we as professionals try to get rid of some of this mystification of deals and the way that we treat one another and start simplifying things for the entrepreneur.

MR. CHERNIAK: Just on the second point, this is a question I get asked a lot by entrepreneurs, and part of it is just the nature of the business. You know, the entrepreneurs, they know they need capital, but frankly, they are not happy about needing it.[23] And some of them actually don't know they need it; they just know that they need something.[24]

Again it is the nature of the business. You are coming in, and you are taking a chunk of an entrepreneur's baby, their dream. So it is kind of a negative starting point almost in nature. I think, as well as the nature of the

[23] *See, e.g.*, Giacinta Cestone, *Venture Capital Meets Contract Theory: Risky Claims or Formal Control?* 3 (2001), *available at* http://www.recercat.net/bitstream/2072/1967/1/48001.pdf.

[24] *Cf. Id.*

business in venture capital, that the women and men in the venture capital business living with this are spread very thin, partly by design.[25]

One has to wonder why the venture capital funds couldn't add more VCs per dollar invested, just so they could spend a little more time, be a little less abrupt in their dealings with people – but at the end of the day, as a VC you really are forced to run from deal to deal, crisis to crisis, opportunity to opportunity, which kind of creates the incentive to be somewhat abrupt and very efficient with your time, so to speak.

I think success also does breed overconfidence in the industry. There certainly is an arrogance wafting through the industry. It is a dog-eat-dog industry, with little love lost between venture capitalists, each seeking to win their way through, compete against other venture capitalists, and get their money into the marquee companies.

You have got to be a sharp-elbowed tough man or woman to do it. The more and more successes you have as a fund, the more the VC becomes a caricature of what they were in the business to begin with--personality quirks get more and more pronounced, since there is no one to set them straight. You, as the VC, end up failing to recognize your own limitations, and you get into an operational groove in terms of the way your fund does business. You will slam a square peg into a round hole because you are a very successful square peg!

Funds tend to try to replicate their successes by doing what they did well in the past, like a pitcher with a good slider and not much else they are very confident in. Your fund may be particularly adept at some particular function like finding new sales channels for software companies or merging investments together or adding aggressive, operationally focused executives in their Rolodex to accelerate the pace of companies getting to the next level. You tend to go sort of back to the things that you are good at, and sometimes again it turns you again into pounding square pegs into round holes, whether your action is optimal or even needed at that moment, or whether the CEO recognizes the need or agrees, that's what you do anyway – turn your companies into the same sort of animal.

And then I think the last point is fairly commonly felt by entrepreneurs – I certainly have seen it. VCs can certainly lack a bit of respect for the effort and skill it has taken to create what has been built to date. This is a difficult and complex issue, and not easily summed up or solved.

MS. HORTON-PANZICA: Among the most frequent complaints that I have heard from entrepreneurs who are accepting venture money is that they end up feeling completely devalued in the process.[26] They are in a situation

---

[25] *See generally* Lorin Cohen, *Writing your Business Plan*, BIOENTREPRENEUR 1 (2002), http://www.nature.com/bioent/building/planning/012003/pf/nbt0602supp-BE33_pf.html.

[26] *See, e.g.*, Ralf Becker & Thomas F. Hellman, *The Genesis of Venture Capital: Lessons*

in which they created a seed of wealth for everybody, and investors lose sight of that.[27]

They created the seed of wealth from which the venture capitalists are going to make these astounding returns, we hope. And somehow in the process of the arrogance of having the money, we forget about the value of the person's creations. And so we set up an aggressive and some sense of animosity between the venture players and the person that has created them.[28]

And I like to think that what we certainly are trying to build into our environment is a different sense of conscience about how we treat entrepreneurs. Entrepreneurs are creative.[29] They are out of the box and they have this sense of creativity, and when you try and stamp it down and press it in and put it in a box and limit it, you have killed it. Until you get the venture capitalist with the right appreciation for that mind set – again back towards that mind set – and appreciating it and valuing it, I think we are trying to inject the wrong kind of personality next to the relationship of the entrepreneur.

DR. KING: Have you had any bad experiences with your new approach, which I think is a good one?

MS. HORTON-PANZICA: I haven't yet. The one situation, which I got back into a good resolution, was that I met a young chap from New York. He was talking about his company in a session that I was in, and I went up to him, and I said, "I am going to invest in you, and I like you. I like who you are, and I am going to let you run with what I see." And I did that, and he was bought six months later by a public company. And that was a good thing.

But as he was exiting, I had a right to take some additional warrants, and I gave that up because the investment was so short because I didn't feel good about taking them. I know that sounds really strange, but I actually didn't feel good about it. I made a huge return.

I gave up warrants, and he had to transfer money to my group, but he didn't pay it for about 90 days. I told him, "You know, I trusted you. I dealt with you with a certain ethic, and you are violating it." Once I sent that e-mail to this chap, we had the money wired within 24 hours.

---

from the German Experience, CESifo Conference Centre 12-16 (Nov. 22-23, 2002) http://www.cesifo-group.de/portal/page/portal/ifoContent/N/neucesifo/CONFERENCES/SC_CONF_1999-2006/VCE02/PAPERS/VCE02-HELLMANN.PDF (unpublished research paper used in CESifo Conference in Munich).

[27] *Id.* at 14.

[28] *Id.* at 12-13.

[29] Debora Markley & Don Mackey, *Community Environment for Entrepreneurship*, CENTER FOR RURAL ENTREPRENEURSHIP, June 2003, at 2, http://www.ruraleship.org/content/content/pdf/Community.pdf.

If you are going to work that way, you have to demand it in return, right, because it is not the environment. But it worked, but you have to keep it real. I am much happier operating that way. I don't want to be in this drag tag ratchet and hatchet. I am not interested.

MR. CHERNIAK: That's actually a good segue to this point, which is, do deal terms actually limit relationships between investors and entrepreneurs?[30] And I think the answer is actually yes. Although I hate to admit, I have done the same thing in terms of not exercising the rights that I legally have in my agreements. At the end of the day, you want to make sure you don't poison the relationship with your entrepreneur, to be penny-wise and pound-foolish.

Although you may be entitled to it under your agreements, if you strip the entrepreneur of too much of their equity and upside, either for underperformance or additional unforeseen capital requirements, the relationship and possibly the investment is eventually going to break down. The entrepreneur is going to lose interest and motivation. They are going to either break down or leave! By the end of the day, you start to wonder whether having all those rights are actually necessary.

Again, although I have to admit that looking forward in negotiating future deals I would probably *still* try to get these weapons. It would be hard to give them up, but I am not sure I would use them. And I think one of the key points in this discussion is that the personal relationship between the VC and the entrepreneur, the chemistry is absolutely paramount in successful investing.

You may have a big institutional fund name; you may have a high-profile, sexy company name with big dollars involved. However, at the end of the day, it is two people, and if it doesn't work, if they don't trust each other or they don't take each other's advice, if they don't listen, the relationship is screwed.

You are not going to be successful, no matter how good your technology is, how good or smart the entrepreneur is, or how smart the VC is. In my mind, it is the most critical aspect of venture capital and the linchpin of success, but it is also the least scientific and the toughest thing to nail. That is why, as I moved over to the advisory side of the relationship between these two animals, it was really to figure out the best way to make sure that match is there, and you are not just taking the best money at the best terms. You are putting together the women and men who fit best with that entrepreneur.

---

[30] *Cf.* TONY BERRY, DAVID LEE, JIA MIAO & ROBERT SWEETING, ACCOUNTING AND ACCOUNTABILITY IN A VENTURE CAPITAL FUNDING PROCESS 2, *available at* http://72.14.205.104/search?q=cache:hvsPNciy08YJ:www.licom.pt/eaa2007/papers/EAA2007_0325_final.pdf+ACCOUNTING+AND+ACCOUNTABILITY+IN+A+VENTURE+CAPITAL+FUNDING+PROCESS+%22tony+berry%22&hl=en&ct=clnk&cd=1 (Investee-entrepreneur relationships are similar to that of principal-agent relationships, where information asymmetry leads to agents limiting effort).

You know, with most of my clients I spent more time than I almost cared to in the trenches, really seeing how they function, how they think, what drives them, what scares the hell out of them, and what changes their behavior. And similarly dealing with a bunch of VCs, as either colleagues or competitors or friends, you see what their hot buttons are; the match is the critical thing.

I think "overly-nasty" agreements tend to keep the two at arms length. The CEO tends to go into a shell, probably for good reason! You know, they are scared to death of losing their company. So maintaining that chemistry is key to a good relationship, in my mind.

MS. HORTON-PANZICA: I think a lot of the relationships get off on the wrong foot because we don't have the money right. So many times I have young entrepreneurs come into our group, and they are either asking for too much money, too little money, or they don't need money when they are asking for it. So they are asking for an engagement with the venture world, when they don't have the quality and quantity of what they actually need to finance.[31]

You automatically set up a situation where a venture capitalist is going to give too much money to an entity and want a deeper return, not enough money and risk wanting a deeper return, or putting money in when they don't really need it and getting a better return, right?[32] So we are setting up the wrong chemistry.

So I think part of a professional's job and part of the venture capitalist's job is to stop that process and sit down with the entrepreneur and say, actually, do you have this quite right? I had a wonderful client from San Francisco, and she had great technology. I would invest tomorrow, but she doesn't need me now. I sent her home and said you don't want my money right now. Keep pressing with friends and family right now.

You are all right like this, and you are going to make it. Come back, and we will raise you around, but you don't need it right now. That was the right thing to say. I think that if you create that sense of trust by taking a look at the mechanics of the money and when it is needed, that's a much better relationship.

The other comment I had here is that rather than looking at the terms that I just read off to you in a basket of rights for the venture money, I like to say to the entrepreneur, this is our environment. I invite you to play in it with us, and if you achieve these three or four or five milestones, if you do this and you are exceptional, you will have rights and money and extra value coming back to you.

---

[31] *See, e.g.*, Rob Holland, *Planning Against a Business Failure*, AGRIC. DEV. CTR – U. TENN., ADC INFO #24 , at 3 (1998) *available at* http://cpa.utk.edu/pdffiles/adc24.pdf.

[32] *Id.*

It is called in our business a clawback.[33] Do I give you a clawback of some of what you have given to me because you truly are exceptional and you can prove it? Then you have given a modicum of respect to this entrepreneur.

It is a different field than all these rights on their own in favor of the venture capitalist.

MR. McCREARY: Cathy, why do you call it a clawback and not an incentive?

MS. HORTON-PANZICA: That's a good point. You are saying you have a right to actually bring it back. The language should change. It is not really an incentive; it is a right to earn back what they had to give up in order to get the equity.[34]

MR. McCREARY: My follow-up question is whether most of the terms can be turned into positives rather than subtractions and negatives?

MS. HORTON-PANZICA: Absolutely.

MR. McCREARY: And if you get that environment, isn't that what happens in the ones that have been winners for you? Have you ever seen it not be the case where the relationship was very positive?

MS. HORTON-PANZICA: Absolutely.

MR. McCREARY: And once there are failures, you are always a failure.

MS. HORTON-PANZICA: There are negatives, and the industry calls it a clawback. I mean, we use these terms. We throw them out; it is aggressive.

The ones that stay when the chemical reaction is right, it is just on fire. It really creates an exciting, positive relationship.

I am going to Toronto next Sunday to go see these entrepreneurs in Toronto. I am counting the days since I am so excited.

So that's the kind of chemistry you want from the person putting money behind you, and I think when that changes, it is like any relationship, right? Once you interject negative comment or aggression into any relationship in your life, it is the same way, right?[35] So what's your conscience – why is your conscience any different when you invest in money? Is it money that makes us gorillas and ugly? I guess.

---

[33] DAVID L. SCOTT, WALL STREET WORDS: AN A TO Z GUIDE TO INVESTMENT TERMS FOR TODAY'S INVESTOR (Houghton Mifflin Company 2003) *available at* http://dictionary.reference.com/browse/clawback (clawback is defined as "[e]xcessive management share of profits that must be refunded to investors of a venture capital fund. A clawback is required when managers of a venture capital fund take a contractual share of early investment gains that are subsequently reduced by losses").

[34] *Id.*

[35] *See e.g.*, Geraldine Downey & Scott I. Feldman, *Implications of Rejection Sensitivity for Intimate Relationships*, 70 J. PERSONALITY & SOC. PSYCHOL. 1327, 1329 (1996), *available at* http://www.columbia.edu/cu/psychology/socialrelations/downloads/rspersonal.pdf.

MR. McCREARY: No. I think it is a question of people not meshing well, and the chemical relationship between the venture capital and the entrepreneur is as important as the money relationship.[36]

MS. HORTON-PANZICA: Well, in our relationships with the people in our lives, we don't have all these ratchets and hatchets and claws and all that stuff going on, do we? We don't talk about it.

I guess what I am saying, why don't we create an environment where we don't have that language exist, and you change it, which is the point you are also making, so that those relationships are supportive and ones that induce success rather than failure.

MR. CHERNIAK: There are different nomenclatures for clawbacks. In my last deal, it was called an "earnback." I have also seen it referred to as a "reverse option," among other things. I have seen a whole bunch of different names, but for me, actually, I find as long as you are negotiating "straight up" with the entrepreneur, it doesn't matter. For example, one term that is in a lot of term sheets that I never accepted and never will is "investment multiplier," which kicks in when you sell a company.[37]

As an example, the venture capital fund puts $5 million into a company. Under this term, the fund must receive or "earnback" $15 million before the entrepreneur and other existing stakeholders get anything. I have always found that to be a backdoor way of negotiating more equity, sometimes without the entrepreneur even understanding the real economic meaning of the term. It is becoming less common these days, although it was very common in the venture capital boom times around 1999 and 2000.[38]

I find when you take out terms like that, that scare the entrepreneur into thinking, "I really need to understand how this REALLY works," if the agreement is more straightforward, you can still keep some aggressive terms in there.[39]

---

[36] *See, e.g.*, Olav Sorenson & Toby E. Stuart, *Syndication Networks and the Spatial Distribution of Venture Capital Investments*, 106 AM. J. OF SOC. 1546, 1549-1551 (2001), *available at* http://leeds-faculty.colorado.edu/bhagat/syndicationnetworksvc-investments.pdf ("Professional relationships provide one of the primary vehicles for accessing timely and reliable information about promising new ventures")

[37] JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 82 (Elizabeth Johnson ed., Harcourt, Inc. 1964) (1953) *available at* http://www.unilibrary.com/books/Keynes,%20John%20Maynard%20-%20The%20General%20Theory%20of%20Employment,%20Interest%20and%20Money.pdf.

[38] *Cf.* Thomas Hellmann & Manju Puri, *The Interaction Between Product Market and Financing Strategy: The Role of Venture Capital*, 13 (4) THE REV. OF FIN. STUD. 959, 980-981 (2000) *available at* http://strategy.sauder.ubc.ca/hellmann/pdfs/RFSofficial.pdf (stating that the number of firms looking to use venture capital is increasing, thus type and terms of investment are more likely to favor entrepreneurs, which controls development path of companies).

[39] *See, e.g.*, Lemon, *supra* note 20, at 6, 7.

If it is a clawback, it is a clawback. As long as it is straightforward, you hope the chemistry of that relationship is solid. It is the kind of stuff that really springs on you later, which the entrepreneur doesn't really understand the effects of it until it hits them in the head or their lawyer informs the what this thing really going to do to them that kills the chemistry and possibly the investment ultimately!

MR. McCREARY: Of course, no guarantee.

MR. CHERNIAK: Oh, you have those, too. But it is when you, as the entrepreneur, are surprised by terms that that were not really highlighted or fully explained in the negotiation, I find that poisons the relationship.

MR. SANDLER: Let's turn to the good, Brad.

MS. HORTON-PANZICA: That's actually a very worthwhile point, part of what poisons the relationship with the venture capitalist. One of my very dear friends who started a business – very successful, invested in by large houses in New York – he is going to leave in the next two or three months with five percent of this company, and he is so bitter.[40]

And the reason why he is going to do that is because he took on equity too soon, and he took on too much, and he didn't need it all, and he gave away the bank, literally. And so, you know, being penny-wise and kind of pound-foolish, giving up equity, he came to me, and he wants to do another company.[41]

He said, "I don't want any venture money at all. I don't want to see it again." This is a guy that is going to start three or four or five companies before he is finished with his career. Probably until he is gone he will be starting new companies, and this is his attitude now. That's sad.

That's why I think the negotiation of the amount of money we actually advise entrepreneurs to pay – and they even have a drawdown. I have done that. I had one deal where I had given him a drawdown and to take what they need, and I get a little richer because the money is drawn, because then they need more from me.

And I have more money at risk, but giving them a drawdown to take what they need as they need it in case things go wrong, that's a very civilized way of financing something.

MR. CHERNIAK: The flipside to that, both of these, to me, are such critical points in terms of how deals get done and whether deals end up being good or bad. To play the devil's advocate for a second – I like doing that.

---

[40] *See generally* Malcolm Baker & Paul A. Gompers, *Executive Ownership and Control in Newly Public Firms: The Role of Venture Capitalists* (November 1999) (unpublished thesis, on file with the Harvard Business School), at 3, *available at* http://www.people.hbs.edu/mbaker/cv/papers/Ownership.pdf.

[41] *See generally* Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. L. REV. 2310, 2329, *available at* http://www.columbialawreview.org/pdf/Baird-Morrison(Web).pdf.

MS. HORTON-PANZICA: Where is your fork?

MR. CHERNIAK: I think it was in the soup last night!

I recently put a deal on ice for an entrepreneur who was too much the other way, too equity-stingy – he could not accept the idea of taking any dilution at all, and, in fact, turned down money that was critically needed for his company. He is at the point where he is growing, but doesn't have a full appreciation of the effect of growth on cash flow. This is actually where most entrepreneurs kind of run off the rails, is not understanding that your business is booming, but it is not going to generate cash flow as quickly as it generates profit. Indeed, it will continue to consume cash in the form of working capital to sustain the growth.

So you *need* a balance sheet to grow your company. I have spent a lot of time on that topic with entrepreneurs, and with this one in particular, I just could not get the point across.[42] And frankly, he could lose his business because of it, for sort of the opposite reason, and that again is being *too* stingy on giving up equity.[43]

There is a balance between the two, not taking too much, not taking too little and the problem extends in both directions.[44]

But let's get to the good stuff! Bottom line, the situation is not so bad. Actually, overall, the relationship is working, and we will talk a little bit about the macro numbers.

But when it does work, I think you will agree it can be a fantastic relationship. VCs can and do fill in the gaps (or weaknesses or blind spots) that all entrepreneurs have to some extent. When they recognize they have these gaps, the relationship can work very well. As an example, a gap could be, you know, being a great operator but not being very good at managing people; or being visionaries in their businesses but not understanding really how to put a business together and make it work and earn sort of the money they need to make their investors happy. So the VCs can be perfect to just to fill in those gaps or blind spots.

Another critical aspect of the VC/entrepreneur relationship is in guiding the entrepreneur to pick the low hanging fruit – the basic elements of what makes a business successful, and sustainable. This blocking and tackling is something every company has to do. If you have been in the corporate finance/venture capital industry for as long as I have been, these points become second nature, but you realize they aren't necessarily as clear to an entrepreneur. You must keep them focused, hew to a flexible, proactive, and reactive strategic plan and use all the resources in the company to their

[42] *See, e.g.*, Lemon, *supra* note 20, at 8.

[43] *Id.*

[44] *Id.*

maximum. This can be, conceptually, fairly simple, but actually much harder said than done.

I think if entrepreneurs have a weakness: sometimes they don't know when to stop.[45] I had one, with a very successful, growing early stage enterprise, a software company for which we executed a financing for very recently. He is just at the cusp of breaking into the U.S. market – big enterprise customers.

His average unit sale going forward will likely be in excess of his total cumulative historical sales, and he will now be dealing with giants such as Boeing and Microsoft and Wal-Mart and those types. That's all fine and nice. You stretch to the max to meet their high expectations and short tempers. He is just barely keeping it together, and he gets a visit from a group of entrepreneurs from Dubai who are setting up sort of a venture capital incubator in the Middle East. Intriguing, but probably ten years away from fruition, and it is going to take a lot of work and a lot of pain, attention and travel – and money. They come to him saying, you know, we would like to incorporate your technology into our concept. All you need to do is provide us with technical and managerial and some executive expertise and some money.

So he brings me in and says, "This looks interesting." My reaction, if you edit out the expletives, was to say nothing! Again, the entrepreneur's creative engine just doesn't have brakes or, perhaps, a steering wheel. The insights of a VC were critical here to avoid a costly and potentially fatal dalliance caused by well-intentioned naivety coupled with endless energy and enthusiasm! The system worked here.

The Company ended up walking away from that opportunity because it was the prudent thing to do, and I think that's what a VC has to do, or an advisor in this case – to focus his efforts and make sure he is focused on his core business, which in this case is enterprise software business – moving from Canada to the U.S. I just don't know why he thought he had all this free time and bandwidth to spend in Dubai, but what are you going to do?

MS. HORTON-PANZICA: Before you go on to the governance piece, it would be interesting – I don't know how many companies you invested in your group – which you would say the entrepreneurs are? Good CEOs? And one of these CEOs, and I was sitting in the back trying to think about that before I spoke, and I am under 50 percent, and therefore, you got a massive blind spot because the point is the entrepreneur wants to be the CEO.

---

[45] *Cf.* Morey Stettner, *CEO Peer Support Can Power a Firm's Business Growth*, INVESTOR'S BUS. DAILY, Mar. 5, 2007, at A11 (Entrepreneur dissuaded from expanding business in favor on focusing on existing firm).

MR. COHEN: I have a question in regards to your initial comment and a most recent comment. That pertains to one of the most important things you look at, and you stated you look at the IP and the cash flow.[46]

MS. HORTON-PANZICA: And the people.

MR. COHEN: That's the key.

MS. HORTON-PANZICA: And the people. I don't even get there until I like the people.

MR. COHEN: Many instances you recognize immediately that the entrepreneur doesn't have the management skill to take it further. And how often do you tell them that before you fund it, that you are going to have to bring in outside management? Do you tell them that initially? Do you wait? What's your process?

MS. HORTON-PANZICA: I don't even get to the IP and cash flow until I see the person is somebody that just excites me with the spark that they have and the drive and the ambition and the foresight for whatever market they are in to be able to drive and drive hard. Otherwise, I am not interested if I don't have that upfront.

I would say I am very honest. I say, "this is what you are good at, and what we need to do is get you this set of management skills. That's something we will do; we will even do it for you until we find the right person." I have done that.

I am doing that right now in a company that I invested in. I love their technology, and they now have been taken in by a large vendor as a software tool. It has been a great investment. The guys that developed the software, I told upfront, that they were going to need help. I put someone on the board, and I have the head of my investment fund actually working alongside these guys constantly on management issues and getting the right management team around them. So I say it upfront because if I am putting money in as a passive investor and see problems, I am actually not interested in that model because I know it is going to fail.

One time I did that recently where I went alongside other investors and stood back. Even though I loved the technology, but I had real doubts whether he could lead and didn't go with my instincts. It has been, at best, challenging.

I think you have to instinctively be very upfront and fill that gap if you are capable. If you managed the P & L and are worried about whether the employees can pay their mortgages, which I have, then, if you cut your teeth on that worry, you can drive management help into the VC environment, where the entrepreneurs never had to worry about that.

---

[46] *See generally* Steven N. Kaplan & Per Strömberg, *How Do Venture Capitalists Choose Investments?* (August 2000) (unpublished thesis, on file with the Graduate School of Business, University of Chicago), *available at* http://isc-capital.com/downloads/aic82k.pdf.

They had just been inventing, right? And now they are taking on employees; they are taking on space; they are taking on cost; and where is the conscience about whether I can pay the bills? Where is my cash flow? Where is my customer base? How am I going to pay my people?

So if that's the mindset you have, you have to put the skills out there, and you have to be the one that sees the blind spot and say, "Here, if you want my money, then you also want this expertise because if you don't want this expertise and us to help you with the management side of this, then don't have my money."

MR. CHERNIAK: We spend a lot of time on transactions of earlier stage companies and the notion of being very upfront with, usually, a CEO or founder about what's likely going to happen after the institutional capital is in, and whether this scenario will be acceptable to them. What's the range of outcomes they are willing to accept in order for the company to be successful – which could be bringing someone in just under them, such as an experienced COO, or in some cases it could be bringing in a new CEO above the founder and putting them into a technology executive role or sales, second-in-command.

We spend a lot of time with the dynamics of what the team is going to look like before and after the money comes in.

MS. HORTON-PANZICA: What's your – you asked a question, what's your – do you agree with what I am saying, or do you have a different approach?

MR. COHEN: No. I agree with what you are saying. I just wonder how much you do with due diligence, use some tools like physiological testing?

MS. HORTON-PANZICA: Yeah.

MR. COHEN: Have you spent time interviewing the spouse?

MS. HORTON-PANZICA: I have not done that.

MR. COHEN: Because you are right, entrepreneurs are a special breed. The conflict you get between the institutional venture capitalist and the entrepreneur very often comes when you intrude on their management, when you try and put that skill set in.[47]

MS. HORTON-PANZICA: Yeah, I agree. It is interesting on the spouse side because I have an investor that is in trouble because the spouse is not supporting the entrepreneur. And it is very, very disappointing. The entrepreneur is a 24-7 pizza-under-the-door kind of guy and the spouse isn't willing to support such a lifestyle when the business requires it.

MR. COHEN: I will close it out. You don't want to hear my war story.

---

[47] *See, e.g.*, Thomas Hellmann, *The Allocation of Control Rights in Venture Capital Contracts*, 29 RAND. J. OF ECON. 57, 59 (1998), *available at* http://strategy.sauder.ubc.ca/hellmann/pdfs/ControlRights.pdf.

MS. HORTON-PANZICA: I love your war story, but that's very interesting. I wonder how violated one might feel saying I want to interview your spouse, but I would like to talk about that a bit more.

MR. CHERNIAK: It goes the other way as well in terms of delving into what the VCs are really like, talking to their investees, talking to their partners. That's a process that we spend a lot of time advising our clients to insist on – that they spend a lot of time with the individual VC that is going to be there going forward, as their director, their guide, and their institutional investor. Entrepreneurs should also meet the VC's partners in social settings, as well as some of their investees. The good funds are only too happy to facilitate this. If they are wary, you have something to worry about.

MS. HORTON-PANZICA: You know, when you are advising an entrepreneur about what type of venture capitalist you want to go to or should go to, it is very important to look at the track record of the money.[48] Those VCs that have great track records of staying in deals, the entrepreneur ought to be interviewing hugely the venture capitalist.

This should be a beauty contest both ways. How have you succeeded? What have you done? Let me interview your investments. Let me talk to the people you dealt with. Let me talk to management of companies because this is a marriage. It is a broker's marriage, and if you get the wrong chemistry, you know the marriage certificate, right?

So, you know, how are we setting up anything that is any different if we don't get the chemistry right between the entrepreneur and the VC? You know, if you have got a young venture firm that has a proven track record, they are going to grandstand investments. They are going to grandstand them. They are going to dump them early. They are going to do early exits to build their portfolios. Do you want to be with a grandstander or do you want to be with somebody that has got a little bit of experience and stayed in investments?

And they put money at risk, and they have been a long-term venture capitalist. They put their money where their mouth is, so it is very important that when you pair the entrepreneurs with the venture capitalists, it is the right kind of venture capitalists.[49]

MR. CHERNIAK: I think we have talked about a lot of these points, but I think one critical one – and again I think we kind of touched on this – but it is a horse sense of how to help the entrepreneur build his team. I think, when I was in the business, in my own mind, I spent half my time on what I call

[48] *See, e.g.*, Rafael Amit, James Brander, & Christoph Zott, *Why do Venture Capital Firms Exist? Theory and Canadian Evidence*, 12 J. OF BUS. VENTURING 441, 444 (1998), *available at* http://strategy.sauder.ubc.ca/brander/papers/Why%20Do%20Venture%20Capital%20Firms%20Exist%201998.pdf.

[49] *See, e.g.*, Sorenson & Stuart, *supra* note 36, at 9.

human resource issues, because one of the biggest areas where a VC can add value is in helping the entrepreneur avoid making big mistakes in hires.[50] Speed them up the learning curve using your own experiences up the same learning curve.

You may have your team of three people, and you are bringing a sales executive or some other critical role, at this point the stakes are so high, an error in judgment could start the chain of events that could be fatal to your business.[51] Early stage companies are all about chemistry and positive momentum, and are not well positioned to recover from disruptions in these areas.

So I think one of the most critical things that a VC brings is not only qualified people to fill that key new role, but the horse sense to figure out whether the fit is mutually right, whether it is the right company for them, and whether they are going to stick it out.[52]

We had one client, a software company based in Montréal, which raided a high-ranking executive from a big public U.S. company, but without realizing how much they were going to have to pay to keep this guy happy in the medium term, in both cash and in common equity of the company – this person was very excited about the company's concept and potential, but at the end of the day, the economics didn't work – neither side really did their homework. This is a very costly mistake for companies.

But I guess I need to pick up the pace here. I would like to talk about the next point for a long time, but why don't we just go on?

MS. HORTON-PANZICA: I think one thing that I would like to say is, as professionals, if you find that the entrepreneur or the venture capitalist has made a bad employment decision, the worst mistake is to try and fix it.[53] Get rid of it. I mean, I think what I have learned, if you try and fix a bad hire or a bad situation, it only gets worse.[54]

It is far better for all professionals involved to say we made a bad decision. Let's go find the right person as soon as possible. You just fix it. Trying to nurse something along is detrimental to the younger business that

---

[50] *See, e.g.*, Robin Broadway & Motohiro Sato, *Entrepreneurship and Symmetric Information in Input Markers* (Sept. 2005) (unpublished paper, collaboration between Broadway of Queens University and Sato of Hitotsubashi University), *available at* http://www.unicatt.it/Dottorati/Defap/Allegati/Boadway_Seminar.pdf.

[51] *Cf. id.*

[52] *Cf. id.*

[53] *See generally* RICHARD LUECKE, HIRING AND KEEPING THE BEST PEOPLE (Harvard Business School Press 2002), *available at* http://slava.parma.ru/Doc/Unsorted/New/BOOKS/Harvard%20Hiring%20and%20Keeping%20the%20Best%20People%20(2002)%20Fly.pdf.

[54] *Cf.* Carolyn L. Rumfelt, *You're Fired, Twice!*, 11 KAN. EMP. L. LETTER, Nov. 2004.

is using its capital on someone that is not who they should be in the business.[55]

And that's not an unkind way of dealing with the world. It is just that your gifts didn't match what we wanted, so there is a very human way of dealing with it. You weren't what we expected, and we need to part ways.

MR. CHERNIAK: Briefly, I think one way to reduce the risk of having that bad one-on-one chemistry is to try to introduce small syndicates to early-stage deals, having two or three VCs rather than one.

Most VCs are not terribly open to a small investment. What can also happen is to sort of force capital down the entrepreneur's throat just to make the deal work. The entrepreneur can be forced to increase the size of the deal, take more capital than he or she perhaps needs, in order to allow each of the funds in the group to deploy enough capital to make the deal worth their while.

So, you know, you now have two or three VCs, with a nice relationship with the entrepreneur. The funds sort of keep each other honest, and they diffuse the power that a VC has going into a relationship with an entrepreneur. Usually one or more of the funds in the group ends up being the "good cop" in the relationship, giving the entrepreneur some needed psychological support.

And in this structure, the funds sort of keep each other in line – even though it might appear that the relationship would be two or three against one now, instead of one-on-one – but the structure again sort of balances things out, frankly, balances the relationship a bit. Really, it kind of diffuses the power, I guess. I encourage this for deals.

MS. HORTON-PANZICA: I love it, and it works beautifully when it is just a little more risk than I want to tolerate. If you think of the number of business plans that we look at, there are hundreds, and the few deals we actually do, it is not that some of the others didn't really take me away, I loved them, but they were just too much risk.[56]

And so the question is whether we can fund some of those opportunities by locking arms in our environment, and you know, we are talking about: do we need venture capital? Absolutely. And we need venture capitalists that are willing to lock on and say, "You know what? We want to share this risk and do it."

And that would enable more deals to be done if we can promote that collaboration amongst people and investors that have the same ethic.[57] You

---

[55] *See generally* LUECKE, *supra* note 53.

[56] *See generally* Brett Nelson, *How to Increase Your Venture Odds*, VENTURE CAPITAL J., May 1, 2005, 2005 WLNR 6846743 (discussing how venture capitalists engage in probabilistic investing by balancing both risk and return).

[57] *See generally* Michael J. Robinson & Thomas J. Cottrell, *Investment Patterns of*

know, that would make a lot of sense to me. If there were ways to promote that, I would encourage us all as professionals to think about it because it would be a huge help to the entrepreneurial world.

MR. CHERNIAK: To address the Canada versus U.S. aspect, which is a key component for this conference, I have found that Canadian transactions are becoming much more like American transactions. There has been a definite convergence of the two, and I think it is both good and bad. Canadian deals and U.S. deals now are really hard to tell apart.[58]

Ten years ago it was vastly different. I could tell in two seconds looking at a term sheet, a letter of intent, or nondisclosure, or any other deal document, whether it was American or Canadian. Now the border is frankly irrelevant in my business. Our deals, we tend to look into geographic "pods," which criss-cross the borders sort of blindly. Most of our analysis is done east-west. The north-south doesn't really matter. The East Coast has its own sort of desires in terms of looking for investments and their own sort of operating styles. Central has one, and the West has one, but they all criss-cross the border.[59]

And the issue for Canada is that it is a small country, with a pretty small pool of capital overall, and that it is never going to have the critical mass that the U.S. market has on several levels.[60]

You know, there is around $22 - 24 billion of venture capital in Canada in total, and last year in the U.S. they raised about $27 billion just last year in the tech field.[61] In the 2000 "bubble" era, it was $105 billion, and Canada raised about $6 billion.[62] So the markets differ by orders of magnitude. I

Informal Investors in the Alberta Private Equity Market. 45 J. SMALL BUS. MGMT 47 (2007), 2007 WLNR 4360035 (discussing that investors choosing to invest based on relationships provide a major source of capital for entrepreneurs).

[58] *See e.g.*, Douglas J. Cumming & Jeffrey G. MacIntosh, *Venture Capital Exits in Canada and the United States*, 53 U. TORONTO L.J. 101, 101-200 (2002) *available at* http://www.rotman.utoronto.ca/cmi/papers/Cummings_MacIntosh.pdf.

[59] *Cf.* Symposium, Global Insight, *Venture Impact 2004 Venture Capital Benefits to the U.S. Economy*, NAT'L VENTURE CAPITAL ASS'N 45 (2004) *available at* http://www.globalinsight.com/publicDownload/genericContent/07-20-04_fullstudy.pdf (explaining that Canada and the U.S. have similar investment styles, operating mostly in early-stage investment, and Canada is largely financed by U.S. based venture funding).

[60] *See generally* SME FINANCING DATA INITIATIVE, SMALL AND MEDIUM-SIZED ENTERPRISE FINANCING IN CANADA – PART IV: PROFILE OF RISK CAPITAL FINANCING (2003), http://strategis.ic.gc.ca/epic/site/sme_fdi-prf_pme.nsf/en/01063e.html ("[T]he regional concentration of venture capital activity in Canada is endemic to the industry.").

[61] *See* JEAN-PHILIPPE CAYEN, VENTURE CAPITAL IN CANADA, BANK OF CANADA, (2001), *available at* http://www.capitalderiesgo.secyt.gov.ar/pdfs/mundo/canada.pdf.

[62] *Cf.* Press Release, National Venture Capital Association, Private Equity Fundraising Recedes in Fourth Quarter, (Jan. 16, 2007), *available at* http://www.nvca.org/pdf/4Q2006Fundraisingfinal.pdf (stating that in 2006 "venture capital saw the highest fundraising year since 2001 with 200 funds raising $28.5 billion.").

think that is a big reason why Canada has become much more like the U.S, and the borders have become really irrelevant.

MS. HORTON-PANZICA: It is really interesting for those people who look abroad. I tend to look at the world rather than the United States, and I think what's interesting is that the rollup strategies of specific VC funds that are industry based are really exciting. I think those are really fun. If you have got a client or an entrepreneur that is in a specialist industry, rolling up the industry globally, a specific fund set up for that purpose with no borders around it can be a good idea.[63]

If you are working entrepreneurs and you are advising entrepreneurs or you are looking for money or thinking about money the other way, I would encourage for you to look for these net-net funds you could pare into an investment. Co-invest, or look at a broader strategy that has got no borders to it.

The world doesn't operate any longer with borders, I believe. I think the way that business and industry works is by looking at the global trend of rolling up an industry and making the most of it and creating a back office for it.[64] What I love to do, the investments I am looking at, which interest me the most, are not only just a rollup of an industry but to roll up the industry and create a share back office for that industry using technology so that you have a complete infrastructure that is shared, lowering the cost of that rollup and leveraging the assets purely upfront.

Does that make sense to everybody? You are actually creating a back office for the industry. You are rolling up this complete shared services model and pulling all the SG & A out of the business, and you drop it into the back office, and then you have an interesting model. That's a great rollup model.

The funds doing that, if you find businesses you can do that with and invest in upfront and roll it up with venture money, that's fabulous, but I don't look at the border stuff any more. I don't think it makes any sense.

MR. SANDLER: Except for the lawyers to some extent, it is up to them to make those borders and to make it as transparent as possible. That's difficult in the U.S.-Canada situation.

---

[63] *See generally* Venture Capital Industry Shatters All Records in 2000, Canada's Venture Capital and Private Equity Association, http://www.cvca.ca/files/Resources/2000overview.pdf (last visited Nov. 23, 2007) (discussing that in 2000 the U.S. invested a record-breaking $103 billion, up by over 73% from 1999 and Canada invested $ 6.3 billion, a 132% increase over the $2.7 billion invested in 1999).

[64] *See generally* DELOITTE, VENTURE CAPITAL GOES GLOBAL (2006), http://www.deloitte.com/dtt/cda/doc/content/dtt_tmt_vcreport_01262006%281%29.pdf (stating that venture capital firms in every region of the world plan to increase their cross border investments).

MR. CHERNIAK: Practically speaking, the government goes out of its way to make sure there is a border, running counter to those flows. Canada has some rather curious laws in my mind that limit American capital going in.[65] We dealt with them for years in terms of the partnerships and limited liability corporations.

And that's a very popular structure in the U.S.[66] Venture capital and private equity funds are structured as partnerships.[67] And for whatever reason, Canada has always had in its mind that they want to limit the ability of those funds to invest in Canada.[68] I never understood this; there is no benefit in my mind.

I am just trying to compress the topic into a very brief statement. I guess it tends to affect VCs more because at the end of the day there are a lot of ways around it in terms of having the proper tax advice and doing all the filings and doing all these sorts of regulatory administrative things we need to do to make sure that you are on site.[69] All the partners can file tax returns and do all their certificates and things, but this adds time and cost to transactions, and the VC – for them it is much more critical because it is a very different business than the private equity business.[70] The dollars involved are much smaller, so the administrative and time and cost and risk of these barriers are much more onerous; they can and do kill venture capital transactions.[71]

MS. HORTON-PANZICA: Isn't the real barrier that you can't make as much money? I mean, the deals – and I am going to come back and be my

---

[65] *See* THOMSON MACDONALD, THE ACTIVITY OF AMERICAN VENTURE CAPITAL FUNDS IN THE ONTARIO MARKET: ISSUES, TRENDS AND PROSPECTS (2005), http://204.15.35.174/images/uploads/ThomsonMacdonald1105.pdf (noting that American investors state that a range of tax issues arise when engaging in cross-border activity with Canada resulting in deals becoming too costly or complex).

[66] *See* William L. Megginson, *Towards a Global Model of Venture Capital?* 12 (The University of Oklahoma, Working Paper, 2001), *available at* http://www.milkeninstitute.org/pdf/Megginson.pdf.

[67] *See id.* at 8-9.

[68] *See generally* MACDONALD, *supra* note 65.

[69] *See generally id.* (discussing that under the *Canada-United States Tax Convention*, American LLCs are subject to taxes arising from their investments in Canada, thus some American corporations choose to affiliate with Delaware corporations and other non-Canadian corporate entities to avoid taxes and other strictures; further, non-resident investors must also file a Section 116 certification when disposing shares in a private Canadian firm – the process can be tedious and can jeopardize returns; other related disclosure requirements are also said to be intrusive).

[70] *Id.* (stating that despite the Delaware strategy and other methods used to facilitate cross-border activity, investors still see investing in Canadian companies as "complex, time-consuming and expensive.").

[71] *Id.* (stating that investors interviewed argued that the costs of investing in Canadian companies "were prohibitive in certain transactions, leading them to consider only those opportunities where they can make exceptionally large investments in Canada.").

own devil's advocate – but the perception of the VC opportunity in Canada is that you just don't have any ROI. The ROI is so much smaller than putting money at risk in the United States that you just can't drive U.S. dollars into the Canadian market.[72]

MR. CHERNIAK: Yeah, there are those perceptions.

MS. HORTON-PANZICA: Saying that, I did two deals in Toronto, so I am going to make money on those deals, but I chose those deals specifically.[73] I think the perception is you can't make money in Canada.

MR. CHERNIAK: Oh, yeah.

MS. HORTON-PANZICA: I think there is that whole piece, that, you know, you cannot put money to – if you put money to work there, you can't get it to work.

MR. CHERNIAK: No, I agree with you completely. Actually, look at the 20-year return on venture capital in Canada: it is low single digits; and in the U.S., it is about 20 percent.[74] And in the last five to ten years, after the 2000 bubble, those returns converged.[75]

The five-year U.S. return is low teens if I recall correctly, which is not bad, better than Canada but not a home run, on average. But by every measure, one-year, five-year, ten-year, twenty-year, Canada does trail the U.S. in venture capital returns.[76] And one of the reasons, frankly, is that it is a structural thing. I don't think it is necessarily fundamental to Canadian companies. It is issues like the labor-sponsored funds, which were government-incentive vehicles to, for reasons other than pure investment fundamentals, put capital into the capital markets.[77]

---

[72] *See generally* CAYEN, *supra* note 61 (stating that in the Canadian venture-capital industry there is "a high risk of making little profit or even of incurring losses.").

[73] *Id.*

[74] *See generally* Charles Plant, *Lightweights in a Heavyweight World*, RED CANARY, Aug. 20, 2006, http://www.redcanary.ca/view/lightweights-in-a (last visited Nov. 8, 2007) ("Rates of return for venture capital investments in Canada for all measurement periods and for all stages of investing are in single digits or negative."); *cf.* Press Release, National Venture Capital Association, Venture Capital Out Performance Holds Steady in Period Ending Q1 2007, (Aug. 2, 2007), *available at* http://www.nvca.org/pdf/Q107VCPerformanceFINAL.pdf (stating that the U.S. venture capital twenty year returns of 16.4%).

[75] *See generally* Jim Casparie, *Raising Money – Can You Really Land Venture Capital?*, ENTREPRENEUR, Mar. 31, 2006, *available at* http://www.entrepreneur.com/money/financing/raisingmoneycoachjimcasparie/article84246.html (explaining that "when the 'dot com' bubble burst and the IPO and mergers and acquisitions (M&A) market virtually disappeared" venture capital firms experienced difficulty receiving a return on their investment).

[76] *See generally* Plant, *supra* note 74.

[77] *See generally* Douglas Cumming, *Financing Entrepreneurs: Better Canadian Policy for Venture Capital*, C.D. HOWE RES. INST., Apr. 15, 2007, 2007 WLNR 9872149 (stating that Labour-Sponsored Venture Capital Corporations (LSVCCs) are Canada's key venture capital initiative to facilitate entrepreneurial investment).

They thought the necessary risk capital to support the entrepreneurial underbelly of the economy was not going to come from the private sphere, so they initiated a 30% tax-credit incentive, in order to draw the capital in.[78] Every dollar you put in, you get 30 cents back via a tax credit, but the problem is the labor-sponsored world created specific rules that these funds had to maintain to keep their status.[79] Well-meaning rules that are, in some cases, silly. For example, one was called the "pacing rule," which essentially meant that the government would dictate how quickly you have to spend the money you raised. And so every November, December typically in the Canadian capital markets, you have LSIFs running around like drunken sailors with their wallets open saying, "I've got to spend this money before year-end. I almost don't care what I do with it. Is it even remotely a reasonable opportunity? If it is, here you go, take my money because it is December. I would have turned the deal away in May!" So there is no way to tell scientifically, but initiatives like these must have hurt returns in the Canadian markets.

MS. HORTON-PANZICA: I think that the statistic here, which you produced, I thought, was unbelievable. It was very great.

MR. CHERNIAK: Yeah, for ten years.

MS. HORTON-PANZICA: Yeah.

MR. CHERNIAK: No. That is skewed by the fact that in the bubble, U.S. investors were making returns that were just off the charts – "thousand percent" returns. If you look at the longer five-year or ten-year U.S. return, it is much more normal.[80] So 20 percent is not sort of a stable return, but it is still, again, big. The U.S. return is better.

MS. HORTON-PANZICA: What would really be interesting actually would be a study of returns on the specific industry sector funds because, if you looked at the returns that were specifically from the Canadian cluster, I bet those returns are fabulous.

So what we have is a mix of all invested monies. I presume that Canada could have an incredible forestry fund venture or whatever assets are up in Canada that I am not aware of, if you think about what assets Canada has and think about how they can be ventured and put into specialist funds and rolled

[78] *See* Ayi Ayayi, *Public Policy and Venture Capital: the Canadian Labor-Sponsored Venture Capital Funds.* 42 J. SMALL BUS. MGMT 335 (2004), 2004 WLNR 9619980 (stating that a benefit to investing in a labor sponsored venture capital fund is a 30-percent tax credit on the investment).

[79] *See generally* Cumming, *supra* note 77 (stating that LSVCCs are bound by many statutory constraints, including "requirements to reinvest fixed percentages of contributed capital in private entrepreneurial companies within a stated period of time.").

[80] *See generally* Press Release, National Venture Capital Association, *supra* note 74 (stating that five-year and ten-year returns on U.S. venture capital is 2.7% and 21% respectively).

up as a global industry. That's where Canada can make a mark. I mean, Canada can make a mark by using its asset base to petition for venture funds, and maybe that's why this is skewed.

MR. SANDLER: Part of the reason why it is skewed is because there is no breakdown between labor-sponsored funds and private venture funds.[81] I think the labor-sponsored funds return certain rollups.

MR. CHERNIAK: Yeah, absolutely. I did sort of a rough calculation on the fly when I was in the business and, absolutely, the overall return for the labor-sponsored returns is fairly dismal.[82]

MR. SANDLER: Negative in many cases.

MR. CHERNIAK: Yeah. In some cases, they were specially focused funds that had shackles that American funds or other sort of generalist venture capital funds didn't have.[83] The one, which I worked with, their charter was to invest in small, capital intensive, labor intensive businesses in the province of Ontario. And that was right around the time that the Indian and Chinese offshore manufacturing assault was hitting its peak. You did the best you could, but when your focus is that specialized and tragically flawed, frankly, let's just say that chunk of capital didn't do very well.

MR. SANDLER: That's labor.

MR. CHERNIAK: Yeah.

DISCUSSION FOLLOWING THE REMARKS OF BRAD D. CHERNIAK AND CATHY HORTON-PANZICA

MR. SANDLER: Aren't there a couple of questions or comments?

DR. KING: Yeah. I had a question. It seems to me the ultimate source of success or failure is technology, and I would like to ask Cathy and also Brad about technology reviews.

Do you have somebody on your staff – or do you have a group that reviews it before you take the plunge or before you take – or do take the entrepreneur's word for it?

MS. HORTON-PANZICA: It is interesting because my partner, he and I between us probably have 40 years of tech or technology experience. So we actually are very deep technologists. Between us, he covers very much

---

81 *See generally* Cumming, *supra* not 77 (arguing that labor sponsored funds "have become the dominant source of venture capital" in fact, "government tax subsidies to LSVCCs may crowd out private venture investment.").

82 *Id.* ("[E]vidence suggests LSVCCs are inefficient investment vehicles, charging high fees and yielding disappointing results: very few funds generate positive returns.").

83 *Id.* (explaining that statutory constraints on labor-sponsored venture funds "include limits on the geographical range of investment opportunities to within the sponsoring jurisdiction, [and] constraints on the size and nature of investment in any given entrepreneurial company.").